

Tax Planning for Early Retirement The Great Resignation

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Today's Presenter



Lawrence Pon

- Lawrence Pon is a Certified Public Accountant, Personal Financial Specialist, Certified Financial Planner, Enrolled Agent, United States Tax Court Practitioner, and Accredited Estate Planner in Redwood Shores, CA
- Mr. Pon has been in practice since 1986 and speaks regularly to tax professionals on the latest tax planning and preparation topics throughout California and nationally.
- Mr. Pon received his BS in Business Administration from UC Berkeley and MS in Taxation from Golden Gate University in San Francisco

The Great Resignation

- The Great Resignation, The Big Quit, The Great Reshuffle
- Pre-pandemic
 - Average resignation rate = 2.4%
- March & April, 2020
 - 13 and 9.3 million workers were laid off
- For the past 2 years, the retired population grew by 3.5 million
 - Pre-pandemic, annual average = 1 million

Tax Planning for Early Retirement

- The Great Resignation
- Retirement Plan Distributions
- Social Security
- Healthcare

Basic Financial Planning

- Spending needs
 - Monthly spending needs
 - Unbudgeted spending needs
 - Periodic spending needs
 - Long term spending needs
- Current Age
- How long will this “retirement” last
- Cash flow

Basic Financial Planning

- Assets
 - Savings Accounts
 - Investments
 - Retirement Plans
- Liabilities
 - Credit card debt
 - Student loans
 - Mortgage
 - Auto Loan

Cashflow

- Less than 1/3 have pensions
- Over half have little savings
- Sources of cashflow
 - Pension
 - Social Security
 - Retirement plan distributions
 - Savings
 - Investments

Pensions

- Defined Benefit Plan
- Earliest age to claim?
- Rollover to IRA?
- How to claim
 - Single life
 - Joint life
- Private vs. Public

Tax Planning

- Where to withdrawal money
- Take advantage of tax brackets
- Avoid penalties

2022 Capital Gains Tax Rates

Tax-filing Status	Single	MFJ	MFS	HOH
0%	\$0 to \$41,675	\$0 to \$83,350	\$0 to \$41,675	\$0 to \$55,800
15%	\$41,676 to \$459,750	\$83,351 to \$517,200	\$41,676 to \$258,600	\$55,801 to \$488,500
20%	\$459,751 or more	\$517,201 or more	\$258,601 or more	\$488,501 or more

2022 Ordinary Tax Rates

Tax Rate	Single	MFJ	MFS	HOH
10%	Up to \$10,275	Up to \$20,550	Up to \$10,275	Up to \$14,650
12%	\$10,276 to \$41,775	\$20,551 to \$83,550	\$10,276 to \$41,775	\$14,651 to \$55,900
22%	\$41,776 to \$89,075	\$83,551 to \$178,150	\$41,776 to \$89,075	\$55,901 to \$89,050
24%	\$89,076 to \$170,050	\$178,151 to \$340,100	\$89,076 to \$170,050	\$89,051 to \$170,050
32%	\$170,051 to \$215,950	\$340,101 to \$431,900	\$170,051 to \$215,950	\$170,051 to \$215,950
35%	\$215,951 to \$539,900	\$431,901 to \$647,850	\$215,951 to \$332,925	\$215,951 to \$539,900
37%	Over \$539,900	Over \$647,850	Over \$332,925	Over \$539,900

Non-retirement Accounts

- Savings
- Brokerage Account
 - Capital Gains
 - Unrealized capital gains
 - Capital gains tax brackets
 - Ordinary tax brackets

Nonqualified Deferred Compensation

- Which distribution option was selected?
 - Lump sum
 - Over 5 years
 - Over 10 years
 - When does it start?
 - Wait one year?
 - Immediately?
 - Tax planning
 - Withholding

Retirement Accounts

- Employer retirement plans
 - Rule of 55
 - Leave your job at any time during or after the calendar year you turn 55
 - Age 50 if public safety employee with a government defined-benefit plan
 - Only apply to employer retirement plan
 - Not IRA
 - Check with Plan Administrator
 - Some plans only allow a lump-sum withdrawal

Retirement Accounts

- Substantially Equal Periodic Payments (SEPP)
 - 72(t)
 - Take recurring annual distributions for either 5 years or until reaching age 59 ½ whichever is longer
- If alter or cancel payment
 - 10% penalty on all distributions previously taken
 - Plus interest

Retirement Accounts

- SEPP – three methods
 - Required minimum distribution method (RMD)
 - The fixed amortization method
 - The fixed annuitization method

Retirement Accounts

- Once SEPP starts, must continue for the longer of 5 years or until reach 59 ½
 - Except for taxpayer's death or disability in the interim
- Example
 - Start SEPP at age 57
 - Maintain for 5 years
 - Start SEPP at age 40
 - Maintain until 59 ½

Retirement Accounts

- If change or cancel payment
 - 10% early distribution penalty retroactively applied to all distributions taken prior to age 59 ½
 - Interest also retroactively applied
- Example
 - Todd started SEPP at age 45
 - At age 55, forgot to take SEPP
 - 10% penalty retroactively applied to prior distributions

Retirement Accounts

- Sally, age 50, \$1 million IRA
 - 120% Mid-term AFR = 1.69% or 5%
 - RMD Method
 - Single life table = \$27,624
 - Uniform life table = \$20,619
 - Fixed Amortization Method
 - Single life table = \$60,312
 - Uniform life table = \$55,177
 - Fixed Annuitization Method
 - Annuity factor (single life) = \$59,308

Early IRA Distributions - Avoiding the 10% Penalty

Taxpayer's Name: Sally
Beneficiary's Name:

Taxpayer's Age 50
Beneficiary's Age

Is the beneficiary the spouse? No

First Year: 2022

IRA Balance: \$ 1,000,000 on December 31, 2021

Interest Rate: 5.00%

First Year Calculations for the Following Methods are Valid Only for 2002 and Later

METHOD 1: The Required Minimum Distribution Method: The IRA balance is divided by taxpayer's life expectancy or joint life expectancy from IRS Pub 590-B tables or the Federal Register, November 12, 2020, pp 72472-72503.

Taxpayer's life (single life table) = 36.2	Annual distribution = \$	27,624
Taxpayer's life (uniform life table) = 48.5	Annual distribution = \$	20,619
Joint life expectancy =	Annual distribution = \$	

METHOD 2: The Fixed Amortization Method: The IRA balance is amortized at 5.00% over taxpayer's life expectancy or joint life expectancy from IRS Pub 590-B tables or the Federal Register, November 12, 2020, pp 72472-72503.

Taxpayer's life (single life table) = 36.2	Annual distribution = \$	60,312
Taxpayer's life (uniform life table) = 48.5	Annual distribution = \$	55,177
Joint life expectancy =	Annual distribution = \$	

METHOD 3: The Fixed Annuitization Method: The IRA balance is annuitized at 5.00% using an annuity factor derived from the mortality table of Rev Ruling 2002-62 or the Fed Reg, November 12, 2020.

Annuity Factor (single life) = 16.861	Annual distribution = \$	59,308
Annuity Factor (joint life) =	Annual distribution = \$	

Distributions in Subsequent Years (2002 and later)

METHOD 1: Distributions after the FIRST year will require looking up the life expectancy each year from the SAME life table that was used in the first year.

Distr. Year: 2023

IRA Balance: \$ 1,000,000 on December 31, 2022

Taxpayer's Current Age: 51

Beneficiary's Current Age:

Select life table used for first year: Single Life Table

Life expectancy = 35.3	Annual distribution = \$	28,329
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METHOD 2 or METHOD 3: Distributions in subsequent years must continue at the same amount for the later of age 59 1/2 or the end of 5 years. If the distribution amount is changed (increased or decreased) prior to the end of the required period, all prior penalties that would have been imposed, will be due and payable, plus interest.

Note: Individuals who selected either the *fixed amortization method* or the *fixed annuitization method* for determining distributions, are permitted a one-time change to the *required minimum distribution method*. Once this change is made, the *required minimum distribution method* must be followed in ALL subsequent years.

Retirement Accounts

- RMD method – recalculate each year
 - Based upon life expectancy and year-end value of IRA
- Amortization and annuitization method
 - Same amount
 - One time change to RMD method

Retirement Accounts

- Example of one time change in method
 - Sam started taking SEPP in 2007 at age 50
 - Annual payment = \$65,809 per the amortization method.
 - 2011 – change to RMD method
 - IRA balance = \$750,000
 - Age 54, Single life expectancy = 30.5
 - New distribution = $\$750,000 / 30.5 = \$24,590$
 - Must use the RMD method for subsequent years

Retirement Accounts

- Other exceptions to the early distribution tax
 - Distributions due to total and permanent disability
 - Up to the amount paid for unreimbursed medical expenses minus 7.5% of AGI
 - IRA distributions made to certain unemployed individuals for health insurance premiums
 - IRA distributions made for qualified higher education expenses
 - Reservists while serving on active duty for at least 180 days

Retirement Accounts

- 401(k) Loans
 - Watch out for repayment terms
 - If not paid back
 - Treated as distribution
 - Subject to 10% early distribution tax

Retirement Accounts

- Net Unrealized Appreciation (NUA)
 - Employer Stock (IRC §402(3)(4))
 - Cost basis taxed as ordinary income
- Retirement Plan Distribution
 - Pre-tax – roll over to IRA
 - Post-tax – roll over to Roth IRA
 - NUA – transfer stock to brokerage account

NUA

- Qualifications
 - The employee must take a lump-sum distribution from the retirement plan
 - No partial distributions are permitted
 - Lump sum distributions must be taken within one year of
 - Separation from your employer
 - Reaching the minimum age for distribution
 - Becoming disabled
 - Being deceased
 - Distribution must include ALL assets from ALL accounts sponsored by and held through the same employer
 - All stock distributions must be taken as shares
 - Cannot be converted to cash
 - However, can “cherry pick” which shares to distribute in kind, and rollover the rest.

NUA

- Qualifications, cont.
 - Entire vested interest in the retirement plan must be distributed
 - Employee may be subject to early distribution penalty (10%)
 - Cost basis is the Fair Market Value (FMV) of the stock at the time of purchase
 - Regardless of whether the employer or employee contributed the money
 - NUA does not receive a step up in basis at death
 - Treated as Income in Respect of a Decedent (IRD)
 - After distribution
 - Long or short term capital gains based upon holding period

NUA

- NUA only applies to employer company stock that was originally purchased and held in a tax-deferred account
 - Not apply to individual stocks of non-employer companies
- Distribution of NUA fulfills RMD requirement
- Capital gains tax rates vs. ordinary tax rates

Net Unrealized Appreciation

- Mitt's 401(k) is currently worth \$1,000,000
 - Company stock, FMV = \$300,000
 - Cost basis = \$50,000
 - Pre-tax contributions = \$400,000
 - Rollover to rollover IRA
 - Post tax contributions = \$300,000
 - Rollover to Roth IRA
 - Tax on NUA is on \$50,000 cost basis as ordinary income
 - Tax on sale of company stock taxed at capital gains rates
 - Capital gain = \$250,000
 - Donate?

Qualified Disaster-Related Distributions

- CARES Act (2020)
 - Coronavirus Related Distributions
- Consolidated Appropriations Act (2021)
 - Qualified Disaster-Related Distributions from Retirement Plans
 - Also loans
- <https://www.irs.gov/newsroom/tax-relief-in-disaster-situations>

Retirement Accounts

- Roth IRAs
 - Qualified Distributions
 - No tax or penalty if:
 - At least age 59 ½
 - It has been at least five years since first contributed to any Roth IRA
 - New five rule applies for any Roth conversions
 - Permanent disability
 - Death distribution
 - Up to \$10,000 to buy, build, or rebuild first home

Retirement Accounts

- Roth IRAs
 - Nonqualified Distributions
 - Do not meet qualified distributions
 - Same exceptions to 10% early distribution tax as traditional IRAs
 - Withdraw contributions penalty free

Additional taxes

- Net Investment Income Tax (NIIT)
 - Investment income less deductions properly allocable to NII
 - Investment income
 - Interest
 - Dividends
 - Annuities
 - Royalties
 - Rents
 - Unless derived in the ordinary course of business
 - Deductions
 - Deductions allocable to the above income

NIIT

- 3.8% Net Investment Income Tax
- 0.9% additional Medicare tax on wage and self-employment income
 - AGI > \$250,000 MFJ
 - AGI > \$200,000 Single & HOH
 - AGI > \$125,000 MFS
 - Thresholds not indexed for inflation

NIIT

- Home Sales
 - Taxable gain will be subject to NIIT
- Retirement plan distributions
 - Not subject to NIIT
 - Roth IRA

NIIT

- Married couple with AGI = \$200,000
 - Sells home with \$540,000 gain
 - \$500,000 exclusion = \$40,000 taxable gain
 - $\$200,000 + \$40,000 < \$250,000$
 - No NIIT
- Gain on home = \$680,000
 - \$180,000 taxable gain
 - $\text{AGI} = \$200,000 + \$180,000 = \$380,000$
 - $\text{NIIT} = 3.8\% \text{ of } \$180,000 = \$6,840$

Social Security

- Eligible at age 62
 - 30% reduction
- Full retirement age
 - Age 66 born from 1943 to 1954
 - Gradual increases from 1955 to 1960
 - Age 67 for anyone born 1960 or later
- Maximize monthly benefit at age 70
 - Increase by 8% until age 70

Social Security

- Early retirement
 - Benefit is reduced by $\frac{5}{9}$ of one percent for each month before normal retirement age, up to 36 months
 - If the number of months exceeds 36, then the benefit is further reduced $\frac{5}{12}$ of one percent per month
 - FRA = 67
 - Claim at 62
 - Number of reduction months = 60
 - Benefit reduced by 30%
 - $36 \times \frac{5}{9}$ of 1 percent plus 24 months $\times \frac{5}{12}$ of 1 percent

Social Security

- Average benefit = \$18,000/year
- 94% take Social Security benefits before age 70
 - Benefit 76% higher if wait
- Also affects spouses and ex-spouses benefits
- $\frac{1}{2}$ of 50 year-olds will live past 80
- $\frac{1}{4}$ of 50 year-olds will live to 90

Social Security

- If working and receiving Social Security before FRA
 - Social Security earnings limit = \$1,630/month or \$19,560/yr
 - \$1 withheld for every \$2 earned above the limit
 - Example: \$2,500/month in Social Security benefits
 - Job pays \$2,000/month
 - $\$2,000 - \$1,630 = \$370$ over limit
 - \$185 will be withheld from Social Security checks
 - When reach FRA, payments will be recalculated to give credit for the withheld portion of benefit

Social Security

- Earnings limit for FRA year is \$51,960
 - If earn more than \$4,330/month before turn FRA
 - \$1 will be withheld from benefit for every \$3 in excess earnings
 - FRA in 2022
 - Benefit = \$2,500/month
 - \$4,500/month from job
 - Excess = \$170/month
 - Reduction in benefits = \$57/month

Social Security

- Adjustment is only temporary
 - Receive credit for reduced benefits once reach full retirement age
 - Bigger Social Security payments later that reflect continued earnings

Social Security

- Tax Planning with Social Security
 - If Adjusted Gross Income plus nontaxable interest and $\frac{1}{2}$ of Social Security benefit is higher than \$25,000 for singles and \$32,000 for married couples
 - Portion of Social Security will be taxable
 - If over \$34,000 for single and \$44,000 for married couples
 - 85% of Social Security subject to taxes

Healthcare

- COBRA
 - Premiums will be higher
 - No employer subsidy
 - 18 to 36 months
- Health Savings Account
 - Withdraw tax free for out-of-pocket medical expenses
 - Insurance premiums through COBRA
 - 20% penalty if not used for medical expenses

Healthcare

- Health Insurance Marketplace
 - Affordable Care Act
 - Premium subsidies
- Spouse's health insurance plan
- Medicare eligibility at age 65

Long Term Care

- Not covered by individual healthcare plans
- Not covered by Medicare
- Family
- Friends
- Pay out-of-pocket
- Medicaid

Tax Planning with Healthcare

- Self Employed Health Insurance Deduction
 - Not subject to 7.5% AGI limitation
 - 100% deductible
 - Earn self-employed income

Self-Employed Health Insurance

- Medical insurance for:
 - Taxpayer
 - Taxpayer's spouse
 - Taxpayer's dependents
 - Any child
 - Who has not reached age 27 at the end of the year

Reverse Mortgage

- Not to exceed 80% of the appraised value of home
- Repayment due
 - When house is sold
 - Borrower dies
 - Ceases to use the home as principal residence
- Interest added to outstanding loan balance monthly as it accrues
- At least 62 years old

Reverse Mortgage

- Tax Planning
 - Loan proceeds not included in recipient's gross income
 - True even if the amount borrowed exceeds the home's basis
 - Interest expense
 - Treated as home equity indebtedness under §163(h)
 - Not deductible for years 2018-2025
 - Unless funds used to substantially improve the residence
 - Reverse mortgage repaid after borrower dies
 - Principal and accrued interest deductible on estate tax return

How to Improve Retirement

- Retire later
- Work part time
- Consult
- Gig economy
- Review budget
- Review investment plan
- Review withdrawal plan
- Consider inflation

Resources

- Form 5329 – Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts
 - <https://www.irs.gov/pub/irs-pdf/f5329.pdf>
 - <https://www.irs.gov/pub/irs-pdf/i5329.pdf>
- Notice 2022-6 – Determination of Substantially Equal Periodic Payments
 - <https://www.irs.gov/pub/irs-drop/n-22-06.pdf>
- Social Security Early Retirement Calculator
 - https://www.ssa.gov/oact/quickcalc/early_late.html

Resources

- Tax Tools
 - <https://www.taxtools.com/>
 - IRA Distribution Before Age 59 ½
 - Plus many helpful worksheets
- Form 8915-F
 - <https://www.irs.gov/pub/irs-pdf/f8915f.pdf>
 - <https://www.irs.gov/pub/irs-prior/i8915f--2022.pdf>

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